3 Fringe Benefits

Certain employer-furnished fringe benefits are exempt from tax if the tests discussed in this chapter are met.

The most common tax-free benefits are accident and health plans, group-term life insurance plans, dependent care plans, education assistance plans, tuition reduction plans, cafeteria plans, and plans providing employees with discounts, no-additional-cost services, or employer-subsidized meal facilities.

Highly compensated individuals may be taxed on certain benefits from such plans if nondiscrimination rules are not met.

Key to Fringe Benefits

Fringe Benefit—	*Tax Pointer—*
Athletic facilities	The fair market value of athletic facilities, such as gyms, swimming pools, golf courses, and tennis courts, is tax free if the facilities are on property owned or leased by the employer (not necessarily the main business premises) and substantially all of the use of the facilities is by employees, their spouses, and dependent children. Such facilities must be open to all employees on a nondiscriminatory basis in order for the company to deduct related expenses.
Child or dependent care plans	The value of day care services provided or reimbursed by an employer under a written, nondiscriminatory plan is tax free up to a limit of $5,000, or $2,500 for married persons filing separately. Expenses are excludable if they would qualify for the dependent care credit; *see* Chapter 25. On your tax return, you must report employer-provided benefits to figure the tax-free exclusion. Tax-free employer benefits reduce eligibility for the dependent care tax credit; *see* ¶3.7.
De minimis (minor) fringe benefits	These are small benefits that are administratively impractical to tax, such as occasional supper money and taxi fares for overtime work, company parties or picnics and occasional theater or sporting event tickets; *see* ¶3.9.
Discounts on company products and services	Services from your employer that are usually sold to customers are tax free if your employer does not incur additional costs in providing them to you; *see* ¶3.15. Merchandise discounts and other discounted services are also eligible for a tax-free exclusion; *see* ¶3.16.
Education plans	A new law has retroactively extended the up-to-$5,250 exclusion to employer-financed undergraduate courses for 1995 through May 31,1997. For graduate courses, the exclusion was extended only through June 30, 1996; *see* ¶3.6.
Employee achievement awards	Achievement awards are taxable unless they qualify under special rules for length of service or safety achievement; *see* ¶3.10.
Group-term life insurance	Premiums paid by employers are not taxed if policy coverage is $50,000 or less; *see* ¶3.3.
Health and accident plan benefits	Premiums paid by an employer are tax free. Benefits under an employer plan are also generally tax free; *see* ¶3.1 and ¶3.2.
Interest-free or low-interest loans	Interest-free loans received from your employer may be taxed; *see* ¶4.30.
Tuition reductions	Tuition reductions for courses below the graduate level are generally tax free. Graduate students who are teaching or research assistants are not taxed on tuition reduction unless the reduction is compensation for teaching services; *see* ¶3.6.
Working condition benefits	Benefits provided by your employer that would be deductible if you paid the expenses yourself are a tax-free working condition fringe benefit. Company cars are discussed at ¶3.5 and other working condition benefits at ¶3.8.

Health, Accident, Group Insurance, and Death Benefits

¶3.1 Tax-Free Health and Accident Coverage Under Employer Plans

You are not taxed on *contributions or insurance premiums* your employer makes to a health or accident plan to cover you, your spouse, or your dependents. If you are temporarily laid off and continue to receive health coverage, the employer's contributions during this layoff period are tax free. If you are retired, you do not pay tax on insurance paid by your former employer. Medical coverage provided to the family of a deceased employee is tax free since it is treated as a continuation of the employee's fringe-benefit package.

If your employer provides health and accident coverage to your live-in companion, the coverage is taxable to you where the companion is not recognized as a "spouse" under state law or "dependent" status is barred (even if support and household membership tests in Chapter 22 are met) because the relationship violates local law.

Tax-free premiums include group hospitalization premiums paid by an employer or former employer if you are retired. Medicare premiums paid by your employer are not taxed. If you retire and have the option of receiving continued coverage under the medical plan or a lump-sum payment covering unused accumulated sick leave instead of coverage, the lump-sum amount is reported as income at the time you have the option to receive it. If you elect continued coverage, the amount reported as income may be deductible as medical insurance if you itemize deductions; *see* ¶17.6.

Benefits received from employer plan. *See* ¶3.2 for the types of health and accident plan benefits that qualify for tax-free treatment.

Continuing coverage for group health plans. Employers are subject to daily penalties unless they offer continuing group health and accident coverage to employees who leave the company and to spouses and dependent children who would lose coverage in the case of divorce or the death of the employee. The employer may charge the employee or beneficiary a premium of up to 102% of the regular premium imposed under the plan for the applicable (individual or family) coverage. The employer must wait at least 45 days after continuing coverage is elected to require payment of premiums.

Continuing coverage rules do not apply to small employers who in the previous calendar year had fewer than 20 employees on a typical day, or government agencies and churches. For other employers, continuing coverage must be offered in these situations:

1. An employee with coverage who voluntarily or involuntarily leaves the company—unless termination is for gross misconduct. Employees who would lose coverage because of a reduction in hours must also be offered continuing coverage. Continuing coverage must also be offered for the employee's spouse and dependent children who were covered before the employee's termination or reduction in hours. If accepted, the coverage must last for at least 18 months. Within this period, an employee who elects continuing coverage is protected against the possibility of a coverage gap if he or she joins a new company that limits group health coverage for pre-existing conditions; the old employer's continuing coverage must remain available.

   Extended coverage may apply to disabled individuals. The coverage period is extended from 18 months to 29 months for individuals who notify the plan administrator within 60 days of a determination under Title II or XVI of the Social Security Act that they are disabled. Before 1997, the disability had to exist when employment terminated or hours were reduced. After 1996, the coverage extension applies if the disability exists at any time during the first 60 days of continuing coverage. During the extended coverage period, the maximum premium that can be charged is increased from 102% to 150% of the applicable premium.
2. On the death of a covered employee, continuing coverage must be offered to the surviving spouse and dependent children who are beneficiaries under the plan on the day before the death. Coverage must be for at least 36 months.
3. If a covered employee obtains a divorce or legal separation, continuing coverage must be offered to the spouse and dependent children for at least 36 months.
4. If a covered employee becomes eligible for Medicare benefits, continuing coverage under the employer's plan must be offered to the employee's spouse and dependent children for at least 36 months.
5. If a dependent child becomes ineligible under the plan upon reaching a certain age, continuing coverage must be offered for at least 36 months.
6. If an employee with health coverage takes unpaid leave under the Family and Medical Leave Act of 1993 (FMLA) upon the birth or adoption of a child or to deal with a serious family illness, and the employee does *not* return to work following the leave, continuing coverage must be offered as of the last day of the leave. Continuing coverage must also be offered to the employee's spouse and dependent children if they would otherwise lose coverage.

Employers must provide written notice of the continuing coverage option. If one of the previously discussed qualifying events occurs, the eligible employees, spouses, and/or dependent children generally have 60 days to elect continuing coverage.

LAW ALERT

MSAs and Long-Term Care Coverage

Starting in 1997, a new law allows employers to make tax-free contributions to employee medical savings accounts (MSAs) and provide tax-free coverage for long-term care. Both benefits are subject to technical conditions and limitations; *see* below.

Medical savings accounts and long-term coverage after 1996. Here are highlights of the new law rules for employer-provided medical savings accounts (MSAs) and long-term care coverage. Further details will be in the Supplement.

After 1996, an employee is not taxed on employer-provided long-term care coverage that pays benefits in the event the employee becomes chronically ill. However, the coverage is not tax free if provided through a cafeteria plan (¶3.13); reimbursements of long-term care expenses may not be made through a flexible spending arrangement (¶3.14). Periodic payments from qualifying contracts are generally tax free up to $175 per day less reimbursements for long-term care expenses. If actual costs for long-term care services exceed the $175 cap, the tax-free limit is increased by the excess.

An MSA resembles an IRA, but its purpose is to meet medical costs not covered by a high-deductible health plan. It may be offered only by employers who on average had no more than 50 employees in either of the two preceding years and who provide high-deductible health plans. The annual deductible must be between $1,500 and $2,250 for individuals and between $3,000 and $4,500 for families. An employee is not taxed on employer MSA contributions of up to 65% of the deductible for single coverage or 75% of the deductible for family coverage. Earnings in an MSA accumulate tax free and distributions are tax free if used to pay medical expenses. A distribution not used to pay medical expenses is subject to regular tax, and, in addition, a 15% penalty, unless made after reaching age 65 or becoming disabled.

¶3.2 Tax-Free Payments From Employer Health and Accident Plans

There are two categories of tax-free benefits paid from employer health and accident plans: (1) reimbursements of medical expenses, and (2) payments for permanent physical injuries. Details on these categories are below.

Benefits not coming within the reimbursement or permanent injury categories are *fully taxable* if: (1) your employer paid all the premiums; and (2) you were not required to report the premiums as taxable income. If you and your employer each paid part of the premiums and you were not taxed on your employer's payment, the portion of the benefits allocable to the employer's contribution is taxed to you. Examples of figuring the taxable portion of the benefits are at ¶17.5. *See* ¶3.1 for benefits from medical savings accounts and long-term care contracts after 1996.

REIMBURSED MEDICAL EXPENSES

Tax-free payments generally include specific reimbursements of medical expenses for yourself, your spouse, or any dependent. Payment does not have to come directly to you to be tax free; it may go directly to your medical care providers.

Tax-free treatment applies only for reimbursed expenses, not amounts you would have received anyway, such as sick leave that is not dependent on actual medical expenses.

Reimbursements for cosmetic surgery do *not* qualify for tax-free treatment, unless the surgery is for disfigurement related to congenital deformity, disease, or accidental injury.

Reimbursements for your *dependents'* medical expenses are tax free, even if you may not claim them as personal exemptions because they had more than $2,550 of income or filed a joint return. Furthermore, if you are divorced and your children have health coverage under your plan, reimbursements of their expenses are not taxable to you, even if your ex-spouse claims them as dependents; *see* ¶22.11.

A qualifying dependent does *not* include a live-in mate where the relationship violates local law.

If the reimbursement is for medical expenses you deducted in a previous year, the reimbursement may be taxable. *See* ¶17.5 for the rules on reimbursements of deducted medical expenses.

If you receive payments from more than one policy in excess of your actual medical expenses, the excess is taxable if your employer paid the entire premium; *see* Examples in ¶17.5.

Self-employed health plan for spouse. A self-employed person is not considered an "employee" for purposes of the tax-free reimbursement rule for medical expenses. However, the IRS in a ruling allowed a self-employed person who hired his spouse to claim a full business deduction on Schedule C for reimbursements of family medical expenses under a written health plan covering all employees, their spouses, and their dependents. The employee-spouse was reimbursed for medical expenses incurred by her husband (the business owner), herself, and their dependent children. She was not taxed on the reimbursements. *See* ¶40.5.

Executives taxed in discriminatory self-insured medical reimbursement plans. Although reimbursements from an employer plan for medical expenses of an employee and his or her spouse and dependents are generally tax free, this exclusion does not apply to certain highly compensated employees and stockholders if the plan is self-insured and it discriminates on their behalf. A plan is self-insured if reimbursement is not provided by an unrelated insurance company. If coverage is provided by an unrelated insurer, these discrimination rules do not apply. If a self-insured plan is deemed discriminatory, rank-and-file employees are not affected; only highly compensated employees are subject to tax.

Highly compensated participants subject to these rules include employees owning more than 10% of the employer's stock, the highest paid 25% of all employees (other than employees who do not have to be covered under the law), and the five highest paid officers.

If highly compensated employees are entitled to reimbursement for expenses not available to other plan participants, any such reimbursements are taxable to them. For example, if only the five highest paid officers are entitled to dental benefits, any dental reimbursements they receive are taxable. However, routine physical exams may be provided to highly compensated employees (but not their dependents) on a discriminatory basis. This exception does not

apply to testing for, or treatment of, a specific complaint.

If highly compensated participants are entitled to a higher reimbursement limit than other participants, any excess reimbursement over the lower limit is taxable to the highly compensated participant. For example, if highly compensated employees are entitled to reimbursements up to $5,000, while all others have a $1,000 limit, a highly compensated employee who receives a $4,000 reimbursement must report $3,000 ($4,000 received minus $1,000 lower limit) as income.

A separate nondiscrimination test applies to plan *eligibility.* The eligibility test requires that the plan benefit: (1) 70% or more of all employees, or (2) 80% or more of employees eligible to participate, provided that at least 70% of all employees are eligible. A plan not meeting either test is considered discriminatory unless proven otherwise. In applying these tests, employees may be excluded if they have less than three years of service, are under age 25, do part-time or seasonal work, or are covered by a union collective bargaining agreement. A fraction of the benefits received by a highly compensated individual from a nonqualifying plan is taxable. The fraction equals the total reimbursements to highly compensated participants divided by total plan reimbursements; benefits available only to highly compensated employees are disregarded. For example, assume that a plan failing the eligibility tests pays total reimbursements of $50,000, of which $30,000 is to highly compensated participants. A highly compensated executive who is reimbursed $4,500 for medical expenses must include $2,700 in income:

$$4,500 \times \frac{30,000}{50,000}$$

Taxable reimbursements are reported in the year during which the applicable plan year ends. For example, in early 1997 you are reimbursed for a 1996 expense from a calendar-year plan. If under plan provisions the expenses are allocated to the 1996 plan year, the taxable amount should be reported as 1996 income. If the plan does not specify the plan year to which the reimbursement relates, the reimbursement is attributed to the plan year in which payment is made.

PERMANENT PHYSICAL INJURIES

Payments from an employer plan are tax free if they are for the permanent loss of part of the body, permanent loss of use of part of the body, or for permanent disfigurement of yourself, your spouse, or a dependent. To be tax free, the payments must be based on the kind of injury and have no relation to the length of time you are out of work or prior years of service. If the employer's plan does not specifically allocate benefits according to the nature of the injury, the benefits are taxable even if an employee is in fact permanently disabled.

EXAMPLE

After he loses a foot in an accident, Marc Jones receives $5,000 as specified in his employer's plan. The payment is tax free because it does not depend on how long Jones is out from work.

An appeals court held that severe hypertension does not involve loss of a bodily part or function and thus does not qualify for the exclusion.

Apart from the exclusion, you may deduct as an itemized deduction any unreimbursed medical expense you have in connection with these injuries subject to the 7.5% adjusted gross income floor; *see* ¶17.4 for details.

Disability payments from profit-sharing plan. The Tax Court has held that a profit-sharing plan may provide benefits that qualify for the exclusion for permanent disfigurement or permanent loss of bodily function. The plan must clearly state that its purpose is to provide qualifying tax-free benefits, and a specific payment schedule must be provided for different types of injuries. Without such provisions, payments from the plan are treated as taxable retirement distributions.

¶3.3 Group-Term Life Insurance Premiums

You are not taxed on your employer's payments of premiums on a policy of up to $50,000 on your life. You are taxed only on the cost of premiums for coverage of over $50,000 as determined by the IRS rates shown in the table on the next page. On Form W-2 your employer should include the taxable amount as wages in Box 1 and separately label the amount in Box 13. You may not avoid tax by assigning the policy to another person.

If two or more employers provide you with group-term insurance coverage, you get only one $50,000 exclusion. You must figure the taxable cost for coverage over $50,000 by using the IRS rates on the next page.

Regardless of the amount of the policy, you are not taxed if, for your entire tax year, the beneficiary of the policy is a tax-exempt charitable organization or your employer.

Your payments reduce taxable amount. If you pay part of the cost of the insurance, your payment reduces dollar-for-dollar the amount includible as pay on Form W-2.

Retirees. If you retired before 1984 at normal retirement age or on disability and are still covered by a company group-term life insurance policy, you are not taxed on premium payments made by your employer even if coverage is over $50,000. If you retired after 1983 because of disability and remain covered by your company's plan, you are not taxed even if coverage exceeds $50,000. Furthermore, if you retired after 1983 and are not disabled, you may qualify for tax-free coverage over $50,000 if the following tests are met:

1. The insurance is provided under a plan existing on January 1, 1984, or under a comparable successor plan;
2. You were employed during 1983 by the company having the plan, or a predecessor employer; and
3. You were age 55 or over on January 1, 1984.

However, even if the three tests are met, you may be taxed under the rule below for discriminatory plans if you retired after 1986 and were a key employee.

Key employees taxed under discriminatory plans. The $50,000 exclusion is not available to key employees unless the group plan meets nondiscrimination tests for eligibility and benefits. Key employees include those who during the year or during any of the four preceding years were: (1) more than 5% owners; (2) more than 1% owners earning over $150,000; (3) one of the 10 largest owners with compensation over $30,000; and (4) officers with 1996 pay over $60,000 (this amount may be adjusted annually for inflation). If the plan discriminates, a key employee's taxable benefit is based on the larger of (1) the actual cost of coverage, and (2) the amount for coverage using the IRS rate table.

The nondiscrimination rules also apply to former employees who were “key” employees when they separated from service. The discrimination tests are applied separately with respect to active and former employees.

Group-term life insurance for dependents. Employer-paid coverage for your spouse or dependents is a tax-free *de minimis* fringe benefit (¶3.9) if the policy is $2,000 or less. For coverage over $2,000, you are taxed on the excess of the cost (determined under the IRS table below) over your after-tax payments for the insurance, if any.

Permanent life insurance. If your employer pays premiums on your behalf for permanent nonforfeitable life insurance, you report as taxable wages the cost of the benefit, less any amount you paid. A permanent benefit is an economic value that extends beyond one year and includes paid-up insurance or cash surrender value, but does not include, for example, the right to convert or continue life insurance coverage after group coverage is terminated. Where permanent benefits are combined with term insurance, the permanent benefits are taxed under formulas found in IRS regulations.

Taxable Rates for Insurance Coverage over $50,000

Age*—	Monthly premium per $1,000 of coverage above $50,000—
Under 30	$0.08
30–34	0.09
35–39	0.11
40–44	0.17
45–49	0.29
50–54	0.48
55–59	0.75
60–64	1.17
65–69	2.10
70 and over	3.76

* Age is determined at end of year.

EXAMPLE

Lynda Jackson is a 52-year-old executive provided with $200,000 of group-term coverage. The taxable amount is $864, based on $150,000 of excess coverage. For every $1,000 of coverage over $50,000, the taxable amount is $0.48 (premium) × 12 (months), or $5.76. Thus, for excess coverage of $150,000, the taxable amount is $864 ($5.76 × $150,000 / $1,000).

If she paid $120 towards the coverage, the taxable amount would be reduced to $744 ($864 – $120).

¶3.4 Employee Death Benefits May Be Tax Free Up to $5,000

The death benefit exclusion of up to $5,000 has been repealed. Repeal is effective for deaths occurring after the date of enactment of the new law. See *the “What's New” page at the front of this book for the enactment date. For beneficiaries of employees who died in 1996 before the new law's enactment, the death benefit exclusion applies as discussed below.*

Exclusion rules prior to repeal. An employer's payment to a deceased employee's beneficiary is tax free up to $5,000 provided: (1) it is paid solely because of the employee's death; *and* (2) the employee did not have a nonforfeitable right to the payment while he or she was alive. An employee had a nonforfeitable right if he or she could have received the amount on demand or when he or she left the job. Payments received from a qualified Keogh plan by beneficiaries of self-employed individuals also qualify.

Where benefits were payable under an annuity contract, ask the company paying the benefits what part of the payments, if any, qualify for the $5,000 exclusion. Regardless of whether the employee had a nonforfeitable right, the exclusion applies to a qualified lump-sum distribution from a qualified pension or profit-sharing plan (¶7.7) or qualified annuity plan for employees of tax-exempt schools and charities; *see* ¶7.20.

Beneficiaries of retired employees who retired on disability before reaching mandatory retirement age under Federal Civil Service laws or the Retired Servicemen's Family Protection Plan may claim the $5,000 exclusion.

The death benefit exclusion per employee may not exceed $5,000 regardless of the number of employers making payments or beneficiaries receiving payments. The $5,000 exclusion is divided among all the beneficiaries. Each claims a part of the exclusion in the same ratio as his or her share bears to the total benefit paid. Interest paid on tax-free death benefits is taxed.

Where benefits are paid over several years, the $5,000 exclusion must be applied to the first payments.

The IRS and the Tax Court hold that if a death benefit exceeds $5,000, the excess is taxable even if the payment was made voluntarily by the employer. Some federal courts have allowed tax-free gift treatment for amounts over $5,000.

EXAMPLES

1. Products Co. pays Kevin Brown's widow a $5,000 bonus due Brown. The bonus is fully taxable. Brown had a right to the payment while he was alive. Similarly, payments for unused leave and uncollected salary are taxable.
2. When Tom Smith died in June 1996, Grand Co. paid his beneficiary a death benefit of $1,000; the amount is tax free because Tom had no right to the amount while alive.

Company Cars, Education Assistance, Dependent Care, and Other Benefits

¶3.5 Company Cars, Parking, and Transit Passes

The costs of commuting to a regular job site are not deductible (¶20.2), but employees who receive transit passes or travel to work on an employer-financed van get a tax break by not having to pay tax on some or all of such benefits.

Where a company car is provided, the value of personal use is generally taxable, as discussed below.

Company cars. The use of a company car is tax free under the working condition fringe benefit rule (¶3.8), provided you use the car for business. If you use the car for personal driving, you may be taxed on the value of such personal use. Your company has the responsibility of calculating taxable income based on IRS tables that specify the value of various priced cars. For certain cars, a flat mileage allowance may be used to measure personal use. You are also required to keep for your employer a mileage log or similar record to substantiate your business use. Your employer should tell you what type of records are required. Similarly, employees who use a company airplane for personal trips are taxable on the value of the flights, as determined by the employer using IRS tables.

Regardless of personal use, you are not subject to tax for a company vehicle that the IRS considers to be of limited personal value. These are ambulances or hearses; flatbed trucks; dump, garbage, or refrigerated trucks; one-passenger delivery trucks (including trucks with folding jump seats); tractors, combines, and other farm equipment; or forklifts. Also not taxable is personal use of school buses, passenger buses (seating at least 20), and moving vans where such personal use is restricted; and police or fire vehicles, or an unmarked law enforcement vehicle, where personal use is authorized by a government agency.

Demonstration cars. The value of a demonstration car used by a full-time auto salesperson is tax free as a working condition fringe benefit if the use of the car facilitates job performance and if there are substantial personal use restrictions, including a prohibition on use by family members and for vacation trips. Furthermore, total mileage outside of normal working hours must be limited and personal driving must generally be restricted to a 75-mile radius around the dealer's sales office.

Chauffeur services. If chauffeur services are provided for both business and personal purposes, you must report as income the value of the personal services. For example, if the full value of the chauffeur services is $30,000 and 30% of the chauffeur's workday is spent driving on personal trips, then $9,000 is taxable (30% of $30,000), and $21,000 is tax free.

If an employer provides a bodyguard-chauffeur for business security reasons, the entire value of the chauffeur services is considered a tax-free working condition fringe benefit if: (1) the automobile is specially equipped for security; and (2) the bodyguard is trained in evasive driving techniques and is provided as part of an overall 24-hour-a-day security program. If the value of the bodyguard-chauffeur services is tax free, the employee is still taxable on the value of using the vehicle for commuting or other personal travel.

How your employer reports taxable automobile benefits. Social Security tax must be withheld. Income tax withholding is not required, but your employer may choose to withhold income tax. If tax is *not* withheld, you must be notified of this fact so that you may consider the taxable benefits when determining whether to make estimated tax installments; *see* Chapter 27. Whether or not withholdings are taken, the taxable value of the benefits is entered on your Form W-2 in Box 12, or on a separate Form W-2 for fringe benefits.

A special IRS rule allows your employer to include 100% of the lease value of using the car on Form W-2, even if you used the car primarily for business. Your employer must specifically indicate on Form W-2 or on a separate statement if 100% of the lease value has been included as income on your Form W-2. If it has, you should compute a deduction on Form 2106 for the business use value of the car. However, this deduction, plus any unreimbursed car operating expenses, may be claimed only as a miscellaneous itemized deduction on Schedule A subject to the 2% AGI floor; *see* ¶19.1.

Your employer may also decide to treat fringe benefits provided during the last two months of the calendar year as if they were paid during the following year. For example, if this election is made for a company car in 1996, only the value of personal use from January through October is taxable in 1996; personal use in November and December is taxable in 1997. If your employer has elected this special year-end rule, you should be notified near the end of the year or when you receive Form W-2.

Employer-provided transit passes and van pooling. For regular employees, up to $65 a month is tax free in 1996 for the combined value of employer-provided transit passes plus commuting on

an employer's van or bus. For example, if in 1996 the monthly value of a transit pass was $70, $5 per month was treated as taxable wages. If the value of benefits was less than $65 in any month, the unused exclusion cannot be carried over to later months. For years after 1996, the $65 monthly exclusion may be adjusted for inflation.

Qualifying transit passes include tokens, fare cards, or vouchers for mass transit or private transportation businesses using highway vehicles seating at least six passengers.

Qualifying van or bus pool vehicles must seat at least six passengers and be used at least 80% of the time for employee commuting; on average, the number of employees must be at least half the seating capacity.

The up-to-$65 monthly exclusion generally applies to cash reimbursements from the employer under a bona fide reimbursement arrangement. However, cash advances are taxable. If an employer has access to vouchers readily exchangeable for transit passes, the vouchers must be used; in that case, cash reimbursements would be taxable.

If your employer gives you a choice between a transit pass worth $50 per month and an extra $50 of pay each month, $50 will be reported as income on your Form W-2 for each month, whether you take the cash or transit pass. Furthermore, if your employer reduces your pay by $50 per month to provide a $50 monthly transit pass, the $50 monthly reduction will be reported as pay on Form W-2 even though you chose otherwise excludable transit pass benefits.

The $65 exclusion applies only to regular employees. For partners, more than 2% S corporation shareholders, and independent contractors who are provided transit passes, the IRS allows up to $21 per month as a tax-free *de minimis* benefit. If the monthly value exceeds $21, the full value is taxable and not just the excess over $21.

Parking provided by employer. For regular employees, the value of employer-provided parking spots or subsidized parking is tax free in 1996 up to a limit of $165 per month. Parking must be on or near the employer's premises, at a mass transit facility such as a train station or car pooling center. The value of parking benefits exceeding $165 per month is taxable in 1996. For years after 1996, the $165 monthly cap may be adjusted for inflation.

The tax will generally apply to employees working in major urban business districts where parking is costly, or in suburban areas where commercial lots are available.

Commuter parking benefits for self-employed partners or more than 2% S corporation shareholders do not qualify for an exclusion and are fully taxable. However, parking benefits provided by the employer while away from the regular office, such as on one-day business trips to other company locations, are generally treated as tax-free working condition fringe benefits (¶3.8) or *de minimis* benefits (¶3.9). Parking benefits provided to independent contractors are also generally tax free as *de minimis* benefits.

According to the IRS, parking benefits are to be valued according to the regular commercial price for parking at the same or nearby locations. For example, if an employer in a rural or suburban location provides free parking for employees and there are no commercial parking lots in the area, the employee parking is tax free. Where free parking is available to both business customers and employees, the employee parking is considered to have "zero" value unless the employee has a *reserved* parking space that is closer to the business entrance than the spaces allotted to customers.

If the value of the right of access to a parking space exceeds $165 in a month, an employee will be taxed on the excess even if he or she actually uses the space for only a few days during the month.

If the employee pays a reduced monthly price for parking in 1996, there is a taxable benefit for that month only if the price paid plus the $165 exclusion is less than the value of the parking.

¶3.6 Education Assistance Plans

If your employer pays for job-related courses, the payment is tax free to you provided that the courses do not satisfy the employer's minimum education standards and do not qualify you for a new profession. If these tests are met, the employer's education assistance is a tax-free working condition fringe benefit (¶3.8).

Even if not job related, up to $5,250 of employer-financed courses may be tax free under a qualifying Section 127 plan; *see* the Law Alert below.

LAW ALERT

Retroactive Extension of $5,250 Exclusion

A new law retroactively extended the up-to-$5,250 exclusion for education assistance provided under nondiscriminatory plans, which had expired at the end of 1994. The revived exclusion applies to undergraduate courses in 1995 and 1996, and for 1997 courses beginning before June 1, 1997. Graduate school courses in 1995 also qualify, but for 1996 the exclusion applies only to graduate courses beginning before July 1, 1996.

If the retroactive extension of the exclusion applies to courses that your employer reported as taxable wages on your Form W-2 for 1995, ask for a corrected Form W-2c. A refund will be available from the employer for withheld Social Security and Medicare taxes. The IRS will also provide expedited refunds for income tax paid on 1995 returns on excludable education benefits.

Tuition reductions. Employees and retired employees of educational institutions, their spouses, and their dependent children are not taxed on tuition reductions for *undergraduate* courses. Widows or widowers of deceased employees or of former employees also qualify. Officers and highly paid employees may claim the exclusion only if the employer plan does not discriminate on their behalf. The exclusion applies to tuition for undergraduate education at any educational institution, not only the employer's school.

Graduate students who are teaching or research assistants at an educational institution are not taxed on tuition reductions for courses at that school if the tuition reduction is in addition to regular pay for the teaching or research services.

The IRS has ruled that the graduate student exclusion for tuition reductions applies only to teaching and research *assistants* and not to faculty or other staff members (or their spouses and dependents) who take graduate courses and also do research for or teach at the school. However, if the graduate courses are work related, a tuition reduction for faculty and staff may qualify as a tax-free working condition fringe benefit (¶3.8).

¶3.7 Dependent Care Assistance

The value of qualifying day-care services provided by your employer under a written, nondiscriminatory plan is generally not taxable up to a limit of $5,000, or $2,500 if you are filing separately. The same tax-free limits apply if you make pre-tax salary deferrals to a flexible spending account for reimbursing dependent care expenses (¶3.14). However, you may not exclude from income more than your earned income. If you are married and your spouse earns less than you do, your tax-free benefit is limited to his or her earned income. If your spouse does not work, all of your benefits are taxable unless he or she is a full-time student or is disabled. If a full-time student or disabled, your spouse is treated as earning $200 a month if your dependent care expenses are for one dependent, or $400 a month if the expenses are for two or more dependents.

Expenses are excludable only if they would qualify for the dependent care credit; *see* Chapter 25. If you are being reimbursed by your employer, the exclusion is not allowed if dependent care is provided by a relative who is your dependent (or your spouse's dependent) or by your child under the age of 19. You must give your employer a record of the care provider's name, address, and tax identification number. The identifying information also must be listed on your return.

Reporting employer benefits on your return. Your employer will show the total amount of your dependent care benefits in Box 10 of your Form W-2. Any benefits over $5,000 will also be included as taxable wages in Box 1 of Form W-2 and as Social Security wages (Box 3) and Medicare wages (Box 5).

If you file Form 1040, you must report the benefits on Part III of Form 2441. If you file Form 1040A, you report the employer benefits on Schedule 2. On these forms, you determine both the tax-free and taxable (if any) portions of the employer-provided benefits. If any part is taxable, that amount must be included on Line 7 of your return as wages and labeled "DCB."

Follow IRS instructions for identifying the care provider (employer, baby-sitter, etc.) on Form 2441 or on Schedule 2 of Form 1040A.

The tax-free portion of employer benefits reduces eligibility for the dependent care credit; see *Chapter 25.*

CAUTION

Figuring Tax-Free Exclusion for Employer-Provided Dependent Care

You cannot assume that your employer-provided dependent care benefit is completely tax free merely because your employer has not included any part of it as taxable wages in Box 1 of Form W-2. Although up to $5,000 of benefits are generally tax free, the tax-free amount is reduced where you or your spouse earns less than $5,000 or where you file separately from your spouse. You must show the amount of your qualifying dependent care expenses and figure the tax-free exclusion on Form 2441 if you file Form 1040, or on Schedule 2 of Form 1040A.

¶3.8 Working Condition Fringe Benefits

An employer-provided benefit that would be deductible by you if you paid for it yourself (¶19.3) is a tax-free working condition fringe benefit. Under IRS regulations, such benefits include:

Company car or plane. The value of a company car or plane is tax free to the extent that you use it for business; *see* ¶3.5 for more on company cars.

Employer-paid business subscriptions or reimbursed membership dues in professional associations.

Product testing. This is a limited exclusion for employees who test and evaluate company manufactured goods away from company premises.

Employer-provided education assistance. Employer-paid undergraduate and graduate courses may be a tax-free working condition fringe benefit if the courses are job related and they do not prepare you for a new profession; *see* ¶3.6.

Job-placement assistance. According to the IRS, job placement services are tax free so long as they are geared to helping the employees find jobs in the same line of work and the employees do not have an option to take cash instead of the benefits. The employer must also have a business purpose for providing such assistance, such as maintaining employee morale or promoting a positive public image.

For tax-free treatment, there is no nondiscrimination requirement; different types of job placement assistance may be offered, or no assistance at all, in the case of discharged employees with readily transferable skills. Tax-free benefits include the value of counseling on interviewing skills and resume preparation. Executives may be given secretarial support and the use of a private office during the job search.

Job placement benefits received as part of a severance pay arrangement are taxable to the extent that cash could have been elected. An offsetting deduction can be claimed only as a miscellaneous itemized deduction subject to the 2% adjusted gross income-floor (¶19.3).

¶3.9 *De Minimis* Fringe Benefits

Small benefits that would be administratively impractical to tax are considered tax-free *de minimis* (minor) fringe benefits. Examples are personal use of company copying machines, company parties, or tickets for the theater or sporting events. Other *de minimis* benefits include:

Occasional overtime meal money or cab fare. If you work overtime and occasionally receive meal money or cab fare home, the amount is tax free. The IRS has not provided a numerical standard for determining when payments are "occasional."

Company eating facility. The operation of a subsidized eating facility for employees is a tax-free *de minimis* fringe benefit if it is located on or near the business premises, and the cost of the meals to employees equals or exceeds the company's operating costs. If meals are not tax-free *de minimus* benefits under this rule, they may still qualify for tax-free treatment where they are provided for a non-compensatory business purpose as discussed at ¶3.11.

Highly compensated employees or owners with special access to executive dining rooms may not exclude the value of their meals as a *de minimis* fringe benefit; however, the meals may be tax free under rules of ¶3.11 if meals must be taken on company premises.

Commuting under unsafe circumstances. If you are asked to work outside of your normal working hours and due to unsafe conditions your employer provides transportation such as taxi fare, the first $1.50 per one-way commute is taxable but the excess over $1.50 is tax free. This exclusion is not available to certain highly compensated employees and officers, corporate directors, or owners of 1% or more of the company.

Even when working their regular shift, hourly employees who are not considered highly compensated ($66,000 in 1996) are taxed on only $1.50 per one-way commute if their employer pays for car service or taxi fare because walking or taking public transportation to or from work would be unsafe. The excess value of the transportation over $1.50 is tax free. These rules can apply to day-shift employees who work overtime as well as night-shift employees working regular hours so long as transportation is provided because of unsafe conditions.

¶3.10 Employee Achievement Awards

Achievement awards are taxable unless they meet special rules for awards of tangible personal property (such as a watch, television, or golf clubs) given to you in recognition of length of service or safety achievement. Cash awards, gift certificates and similar items are taxable. As a general rule, if your employer is allowed to deduct the cost of the award, you are not taxed. The deduction limit, and therefore the excludable limit, is $400 for awards from nonqualified plans and $1,600 for awards from qualified plans or from both qualified and nonqualified plans. If your employer's deduction is less than the item's cost, you are taxed on the greater of: (1) the difference between the cost and your employer's deduction, but no more than the award's fair market value; or (2) the excess of the item's fair market value over your employer's deduction. Deduction tests for achievement awards are discussed at ¶20.25. It is up to your employer to tell you if the award qualifies for full or partial tax-free treatment.

An award will not be treated as a tax-free safety achievement award if employee safety achievement awards (other than those of *de minimis* value) were granted during the year to more than 10% of employees (not counting managers, administrators, clerical employees, or other professional employees). An award made to a manager, administrator, clerical employee, or other professional employee for safety achievement does not qualify for tax-free treatment.

Tax-free treatment also does not apply when you receive an award for length of service during the first five years of employment or when you previously received such awards during the last five years, unless the prior award qualified as a *de minimis* fringe benefit.

CAUTION

Underpriced Items

If the value of the item is disproportionately high compared to the employer's cost, the IRS may conclude that the award is disguised compensation, in which case the entire value would be taxable.

Meals and Lodging

¶3.11 Employer-Furnished Meals or Lodging

The value of employer-furnished *meals* is not taxable if furnished on your employer's business premises for his or her convenience. The value of *lodging* is not taxable if, as a condition of your employment, you must accept the lodging on the employer's business premises for the employer's convenience.

The key words here are: business premises, convenience of the employer, and condition of employment. For *meals*, you must satisfy the business premises and convenience of employer tests. For *lodging*, you must satisfy these two tests plus the condition of employment test.

Business premises test. The IRS generally defines business premises as the place of employment, such as a company cafeteria in a factory for a cook or an employer's home for a household employee. The Tax Court has a more liberal view, extending the area of business premises beyond the actual place of business in such cases as these:

- A house provided a hotel manager, although located across the street from the hotel. The IRS has agreed to the decision.
- A house provided a motel manager, two blocks from the motel. However, a court of appeals reversed the decision and held in the IRS's favor.
- A rented hotel suite that is used daily by executives for a luncheon conference.

COURT DECISION

House One Block Away

Two federal courts held that a school superintendent received tax-free lodging where the home was one block away from the school and separated by a row of other houses. This met the business premises test. The IRS disagrees with the result and says that it will continue to litigate similar cases arising outside of the Eighth Circuit in which the case arose. The Eighth Circuit includes the states of Arkansas, Iowa, Minnesota, Missouri, Nebraska, and North and South Dakota.

Convenience of employer. This requires proof that an employer provides the free meals or lodging for a business purpose other than providing extra pay. However, that the board and lodging are described in a contract or state statute as extra pay does not bar tax-free treatment provided they are *also* furnished for other substantial, noncompensatory business reasons; for example, you are required to be on call 24 hours a day, or there are inadequate eating facilities near the business premises.

Generally, the value of meals furnished before or after working hours or on nonworking days is taxable, but there are exceptions; *see* the Examples below.

EXAMPLES

1. A waitress who works from 7 a.m. to 4 p.m. is furnished two meals a day without charge. Her employer encourages her to have her breakfast at the restaurant before working, but she is required to have her lunch there. The value of her breakfast and lunch is not income because it is furnished during her work period or immediately before or after the period. But say she is also allowed to have free meals on her days off and a free supper on the days she works. The value of these meals is taxable income because they are not furnished during or immediately before or after her work period.
2. A hospital maintains a cafeteria on its premises where all of its employees may eat during their working hours. No charge is made for these meals. The hospital furnishes meals to have the employees available for emergencies. The employees are not required to eat there. Since the hospital furnishes the meals in order to have employees available for emergency call during meal periods, the meals are not income to any of the hospital employees who obtain their meals at the hospital cafeteria.
3. You are required to occupy living quarters on your employer's business premises as a condition of employment. The value of any meal furnished to you without charge on your employer's premises is excluded from taxable income.
4. In order to assure adequate bank teller service during the busy lunch period, a bank limits tellers to 30 minutes for lunch and provides them with free meals in a cafeteria on the premises so they can eat within this time period. The value of the meals is tax free.

Meal charges. Your company may charge for meals on company premises and give you an option to accept or decline the meals. However, by law, the IRS must disregard the charge and option factors in determining whether the meals are furnished for the convenience of your employer.

Where your employer provides meals on business premises at a fixed charge which is subtracted from your pay whether you accept the meals or not, the amount of the charge is excluded from your taxable pay. If the meal is provided for the employer's convenience, as in the previous Examples, the value of the meals received is also tax free. If it is not provided for the employer's convenience, the value is taxable whether it exceeds or is less than the amount charged.

CAUTION

Partners Are Not Employees

The IRS does not consider partners or self-employed persons as employees and so does not allow them an exclusion under the rules of this section. The IRS also does not allow a partnership to deduct the cost of meals and lodging provided a partner-manager of a hotel. Courts are split on this issue.

Lodging must be condition of employment. This test requires evidence that the lodging is necessary for you to perform your job properly, as where you are required to be available for duty at all times. The IRS may question the claim that you are required to be on 24-hour duty. For example, at one college, rent-free lodgings were provided to teaching and administrative staff members, maintenance workers, dormitory parents who supervised and resided with students, and an evening nurse. The IRS ruled that only the lodgings provided to the dorm parents and the nurse met the tax-free lodging tests because for the convenience of the college, they had to be available after regular school hours to respond to emergencies.

If housing is provided to some employees with a certain job and not others, the IRS may hold that the lodging is not a condition of employment. For example, the IRS taxed medical residents on the value of hospital lodging where other residents lived in their own apartments.

If you are given the choice of free lodging at your place of employment or a cash allowance, the lodging is not considered to be a condition of employment, and its value is taxable.

If the lodging qualifies as tax free, so does the value of employer-paid utilities such as heat, electricity, gas, water, sewerage, and other utilities. Where these services are furnished by the employer and their value is deducted from your salary, the amount deducted is excluded from taxable wages on Form W-2. But if you pay for the utilities yourself, you may not exclude their cost from your income.

Are Your Board and Lodging Tax Free?

Yes—	*No—*
A state civil service employee working at a state institution who is required to live at the institution and eat there so he or she may be available for duty at any time. Hotel executives, managers, housekeepers, and auditors who are required to live at the hotel. Domestics, farm laborers, fishermen, canners, seamen, servicemen, building superintendents, and hospital and sanitarium employees who are required to have meals and lodging on employer premises. Restaurant and other food service employees who have meals furnished during or immediately before or after working hours. Employees who must be available during meal periods for emergencies. Employees who, because of the nature of the business, must be given short meal periods. Workers who have no alternative but to use company-supplied facilities in remote areas. Park employees who voluntarily live in rent-free apartments provided by a park department in order to protect the park from vandalism.	Your employer gives you a cash allowance for your meals or lodgings. You have a choice of accepting cash or getting the meals or lodging. For example, under a union contract you get meals, but you may refuse to take them and get an automatic pay increase. A state hospital employee is given a choice. He or she may live at the institution rent free or live elsewhere and get extra pay each month. Whether he or she stays at the institution or lives outside, the extra pay is included in his or her income. A waitress, on her days off, is allowed to eat free meals at the restaurant where she works.

EXAMPLE

Tyrone Jones is employed at a construction project at a remote job site. His pay is $600 a week. Because there are no accessible places near the site for food and lodging, the employer furnishes meals and lodging for which it charges $120 a week, which is taken out of Jones's pay. Jones reports only the net amount he receives—$480. The value of the meals and lodging is a tax-free benefit.

Groceries. An employer may furnish unprepared food, such as groceries, rather than prepared meals. Courts are divided on whether the value of the groceries is excludable from income. One court allowed an exclusion for the value of nonfood items, such as napkins and soap—as well as for groceries—furnished to a doctor who ate at his home on the hospital grounds so that he would be available for emergencies.

Cash allowances. A cash allowance for meals and lodging is taxable. Only meals furnished in kind are permitted tax-free treatment.

EXAMPLE

A hotel manager's wife bought groceries, the cost of which was reimbursed by the hotel. Milk was delivered to their apartment and paid for by the hotel. The reimbursement of the grocery bills was taxable because the groceries were not furnished in kind by the hotel. However, the cost of the milk was not taxable because the delivery to the apartment and the payment of the bill by the hotel was considered food furnished in kind.

Faculty lodging. Teachers and other employees of an educational institution (or their spouses and dependents) do not have to pay tax on the value of school-provided lodging if they pay a minimal rent. The lodging must be on or near the campus. The minimal required rent is the smaller of: (1) 5% of the appraised value of the lodging; or (2) the average rental paid for comparable school housing by persons who are neither employees nor students. Appraised value must be determined by an independent appraiser and the appraisal must be reviewed annually.

For 1996 and later years, a new law extends the 5% minimum rent rule to employees of medical teaching hospitals and medical research organizations with regular faculties and curricula in basic and clinical medical science and research. The new law also specifies that the 5% rent rule applies to employees of a state university system.

EXAMPLE

Carol Enge, a professor, pays annual rent of $6,000 for university housing appraised at $100,000. The average rent for comparable university housing paid by non-employees and non-students is $7,000. She does not have to pay any tax on the housing since her rental payments exceed 5% of the appraised housing value (5% of $100,000, or $5,000). If her rent was $4,000, she would have to report income of $1,000 ($5,000 minimum required rent – $4,000).

Peace Corps and VISTA volunteers. Peace Corps volunteers working overseas may exclude subsistence allowances from income under a specific code provision. The law does not provide a similar exclusion for the small living expense allowances received by VISTA volunteers.

¶3.12 Minister's Rental Allowance

A duly ordained minister pays no tax on the rental value of a home provided as part of his or her pay. If a minister is provided with a rental allowance rather than a home itself, the allowance is tax free if the entire amount is used to pay rent (including the rent of a furnished or unfurnished apartment or house, garage, and utilities).

A housing allowance is also tax free if used as a down payment to buy a house, or used to pay mortgage installments, or for utilities, interest, tax, and repair expenses of the house. Any part of the allowance not used for these housing purposes is taxed. For example, that part of an allowance used to pay rent on business or farm property or for food or the services of a maid is taxed.

A minister who rents his or her home while abroad on church business may exclude his or her rental allowance only up to amounts used for capital improvements. These amounts are treated as expenses of keeping up his or her regular home. The balance of the rental allowance is taxable compensation even though he or she had expenses for maintenance, interest, taxes, repairs, and utilities during the rental period. The expenses may be deducted from rental income.

Allowance Must Be Authorized

The church or local congregation must officially designate the part of the minister's compensation that is a rental allowance. To qualify for tax-free treatment, the designation must be made in advance of the payments. Official action may be shown by an employment contract, minutes, a resolution, or a budget allowance.

Who qualifies for tax-free allowance? Tax-free treatment is allowed to ordained ministers, rabbis, and cantors who receive housing allowances as part of their compensation for ministerial duties. Retired ministers qualify if their allowance is furnished in recognition of past services.

The IRS has allowed the tax-free exclusion to ministers working as teachers or administrators for a parochial school, college, or theological seminary which is an integral part of a church organization. A traveling evangelist was allowed to exclude rental allowances from out-of-town churches to maintain his permanent home. Church officers who are not ordained, such as a "minister" of music (music director) or "minister" of education (Sunday School director), do not qualify.

The IRS has generally barred an exclusion to ordained ministers working as executives of nonreligious organizations even where services or religious functions are performed as part of the job. The Tax Court has focused on the duties performed. A minister employed as a chaplain by a municipal police department under church supervision was allowed a housing exclusion, but the exclusion was denied to a minister-administrator of an old-age home that was not under the authority of a church and a rabbi who worked for a religious organization as director of inter-religious affairs.

Allowance subject to self-employment tax. Although parsonage allowances are not taxable income, they are reported as self-employment income for Social Security purposes; *see* Chapter 46. If you do not receive a cash allowance, report the rental value of the parsonage as self-employment income. Rental value is usually equal to what you would pay for similar quarters in your locality. Also include as self-employment income the value of house furnishings, utilities, appurtenances supplied—such as a garage—and the value of meals furnished that meet the rules at ¶3.11.

Cafeteria Plans and Flexible Spending Arrangements

¶3.13 Cafeteria Plans Provide Choice of Benefits

"Cafeteria plans" is a nickname for plans that give an employee a choice of selecting either cash or at least one qualifying nontaxable benefit. You are not taxed when you elect qualifying nontaxable benefits, although cash could have been chosen instead. A cafeteria plan may offer benefits such as group health insurance or life insurance coverage, long-term disability coverage, dependent care assistance, or medical expense reimbursements.

Employees may be offered a premium-only plan (POP), which allows them to purchase group health insurance coverage or life insurance on a pre-tax basis using salary reduction contributions.

Under a flexible spending arrangement (FSA), employees may be allowed to make tax-free salary-reduction contributions to a medical or dependent care reimbursement plan; *see* ¶3.14.

A qualified cafeteria plan must be written and not discriminate in favor of highly compensated employees and stockholders. If the plan provides for health benefits, a special rule applies to determine whether the plan is discriminatory. If a plan is held to be discriminatory, the highly compensated participants are taxed to the extent they could have elected cash. Furthermore, if key employees (¶3.3) receive more than 25% of the "tax-free" benefits under the plan, they are taxed on the benefits.

¶3.14 Flexible Spending Arrangements

A flexible spending arrangement (FSA) allows employees to get reimbursed for medical or dependent care expenses from an account they set up with pre-tax dollars. Under a typical FSA, you agree to a salary reduction which is deducted from each paycheck and deposited in a separate account. As expenses are incurred, you are reimbursed from the account. Funds from a health FSA may be used to reimburse you for the annual deductible under your employer's regular health plan, co-payments you must make to physicians, and any other expenses that your health plan does not cover. These may include eye examinations, eyeglasses, routine physicals, and orthodontia work for you and your dependents. However, a health FSA may not be used to pay for health insurance premiums, including group health insurance premiums incurred by your spouse.

The tax advantage of an FSA is that your salary reduction contributions are not subject to federal income tax or Social Security taxes, allowing your medical or dependent care expenses to be paid with pre-tax rather than after-tax income. The salary deferrals are also exempt from state and local taxes except in New Jersey and Pennsylvania; check with the administrator of your employer's plan.

In the case of a health FSA, paying medical expenses with pre-tax dollars allows you to avoid the 7.5% adjusted gross income (AGI) floor (¶17.1) that limits itemized deductions for medical costs.

However, to get these tax advantages, you must assume some risk. Under a "use it or lose it rule," if your out-of-pocket expenses for the year are less than your contributions, the balance is forfeited, as discussed below.

FSA restrictions. The IRS has imposed restrictions on FSAs that make them unattractive for many employees. An election to set up an FSA for a given year must be made before the start of that year. You elect how much you want to contribute during the coming year and that amount will be withheld from your pay in monthly installments. Once the election takes effect, you may not discontinue contributions to your account and elect to receive the amounts as compensation unless there is a change in family status.

In addition, only expenses incurred during the plan year may be reimbursed, and a "use it or lose it" rule applies: any unused balance at the end of the plan year is forfeited. Unused amounts may not be refunded to you or carried over to the next year. There is a grace period, generally until April 15 of the following year, to submit reimbursement claims for expenses incurred during the previous year.

Although there are some differences in the reimbursement rules for health care and dependent care FSAs, as discussed below, the "use it or lose it" feature applies to both.

EXAMPLE

At the end of 1996 you elect to make 1997 salary reduction contributions of $600 to a health care FSA. If you incur only $500 of reimbursable medical expenses during the year, the $100 balance is forfeited; you are not allowed to carry it forward to 1998.

Health care FSA. At all times during the year, you may receive reimbursements up to your designated limit, even if your payments to the FSA are less. For example, if you elect to make salary-reduction contributions of $100 per month to a health care FSA, and you incur $500 of qualifying medical expenses in January, you may get the full $500 reimbursement even though you have paid only $100 into the plan. Your employer may not require you to accelerate contributions to match reimbursement claims.

You may *not* receive tax-free reimbursements for cosmetic surgery expenses unless the surgery is necessary to correct a deformity existing since birth or resulting from a disease or from injury caused by an accident. Nonqualifying reimbursements are taxable.

Employees on medical or family leave. Employees who take unpaid leave under the Family and Medical Leave Act (FMLA) to deal with medical emergencies or care for a newborn child may either continue or revoke their coverage during FMLA leave. If the coverage continues, the maximum reimbursement selected by that employee must be available at all times during the leave period. If the coverage is terminated, the employee must be reinstated under the FSA after returning from the leave, but no reimbursement claims may be made for expenses incurred during the leave.

Estimating FSA Contributions

Because of the "use it or lose it" rule for FSA contributions, make a conservative estimate of your expenses when you make your election. This is particularly true for medical expenses which are generally difficult to project in advance.

Dependent care FSA. You may contribute to a dependent care FSA if you expect to have dependent care expenses qualifying for the tax credit discussed in Chapter 25, but if you contribute to a dependent care FSA, *any tax-free reimbursement from the account reduces the expenses eligible for the credit.* If you are married, both you and your spouse must work in order for you to receive tax-free reimbursements from an FSA, unless your spouse is disabled or a full-time student; *see* ¶3.7.

The maximum tax-free reimbursement under the FSA is $5,000, but if either you or your spouse earns less than $5,000, the tax-free limit is the lesser earnings. If your spouse's employer offers a dependent care FSA, total tax-free reimbursements for both of you are limited to $5,000. Furthermore, if you are considered a highly compensated employee, your employer may have to lower your contribution ceiling below $5,000 to comply with nondiscrimination rules.

Unlike health FSAs, an employer may limit reimbursements from a dependent care FSA to your account balance. For example, if you contribute $400 a month to the FSA, and in January you pay $1,500 to a day care center for your child, your employer may reimburse you $400 a month as contributions are made to your account.

Tax-Free Dependent Care Reimbursements

Whether all or only part of your dependent care FSA reimbursements are tax free is figured on Part III of Form 2441 if you file Form 1040. If you file Form 1040A, the calculation is made on Part III of Schedule 2.

Free or Low-Cost Company Services or Products

¶3.15 Company Services Provided at No Additional Cost

Employees are not taxed on the receipt of services usually sold by their employer to customers where the employer does not incur additional costs in providing them to the employees. Examples are free or low-cost flights provided by an airline to its employees; free or discount lodging for employees of a hotel; and telephone service provided to employees of telephone companies. These tax-free fringes also may be provided to the employee's spouse and dependent children; retired employees, including employees retired on disability; and widows or widowers of deceased or retired employees. Tax-free treatment also applies to free or discount flights provided to parents of airline employees. Benefits provided by another company under a reciprocal arrangement, such as standby tickets on another airline, may also qualify as tax free.

The employer must have excess service capacity to provide the service and not forego potential revenue from regular customers. For example, airline employees who receive free reserved seating on company planes must pay tax on the benefit because the airline is foregoing potential revenue by reserving seating that could otherwise be sold.

Highly compensated employees. Highly compensated employees can receive tax-free company services *only if* the same benefits are available to other employees on a nondiscriminatory basis. Highly compensated employees in 1996 include employees owning more than a 5% interest, employees earning more than $100,000, employees earning over $66,000 if in the top-paid 20%, and officers earning more than $60,000. The $60,000, $100,000, and $66,000 amounts are subject to annual inflation adjustments.

Line of business limitations. If a company has two lines of business, such as an airline and a hotel, an employee of the airline may not receive tax-free benefits provided by the hotel. However, there are exceptions. An employee who provides services to both business lines may receive benefits from both business lines. Benefits from more than one line in existence before 1984 may also be available under a special election made by the company for 1985 and later years. Your employer should notify you of this tax benefit.

¶3.16 Discounts on Company Products or Services

The value of discounts on company products is a tax-free benefit if the discount does not exceed the employer's gross profit percentage. For example, if a company's profit percentage is 40%, the maximum tax-free employee discount for merchandise is 40% of the regular selling price. If you received a 50% discount, then 10% of the price charged customers would be taxable income. The employer has a choice of methods for figuring profit percentage.

Discounts on services that are not tax free under ¶3.15 for no-additional-cost services qualify for an exclusion, limited to 20% of the selling price charged customers. Discounts above 20% are taxable. An insurance policy is treated as a service. Thus, insurance company employees are not taxed on a discount of up to 20% of the policy's price.

Some company products do not qualify for the exclusion. Discounts on real estate and investment property such as securities, commodities, currency, or bullion are taxable. Interest-free or low-interest loans given by banks or other financial institutions to employees are not excludable. The loan is subject to tax under the rules of ¶4.31.

The line of business limitation discussed at ¶3.15 for no-additional-cost services also applies to qualified employee discounts. Thus, if a company operates an airline and a hotel, employees who work for the airline may generally not receive tax-free hotel room discounts. However, if a special election was made by the company, employees may receive tax-free benefits from any line of business in existence before 1984.

Highly compensated employees are subject to the nondiscrimination rules discussed at ¶3.15 for no-additional-cost services.

EXAMPLE

The airline that you work for gives you a free round-trip ticket with a confirmed seat to California. The benefit is not tax free under the rule for no-additional-cost services (¶3.15), but a 20% tax-free discount is allowed. If customers are charged $600 for comparable tickets, $120 is a tax-free benefit (20% of $600) and $480 is taxable.